No. 77-648

In the Supreme Court of the United States

OCTOBER TERM, 1977

FEDERAL ENERGY REGULATORY COMMISSION, PETITIONER

v.

PENNZOIL PRODUCING COMPANY, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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CITATIONS

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The Solicitor General, on behalf of the Federal Energy Regulatory Commission,[1] petitions for a writ

[1] On September 30, 1977, pursuant to the provisions of the Department of Energy Organization Act (DOE Act), Pub. L. 95-91, 91 Stat. 565 and Executive Order No. 12009, 42 Fed. Reg. 46267, the Federal Power Commission ceased to exist. Its functions and regulatory responsibilities were transferred to the Secretary of Energy and the Federal Energy Regulatory Commission which, as an independent commission within the Department of Energy, was activated on October 1, 1977. Pursuant to Section 402(a)(1)(C) of the DOE Act, "the establishment, review, and enforcement of rates and charges for the transportation and sale of natural gas" in interstate commerce is "transferred to, and vested in," the Federal Energy Regulatory Commission. The "savings provisions" of Section 705 of the DOE Act provide for the substitution of the Federal Energy Regulatory Commission for the Federal Power Commission in pending litigation such as this case.

of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit.

OPINIONS BELOW

The opinion of the court of appeals (App. A, *infra*, pp. 1a-9a) is reported at 553 F. 2d 485. The initial opinion and order (No. 753) of the Federal Power Commission (App. D, *infra*, pp. 14a-26a) and its opinion and order (No. 753-A) denying rehearing (App. E, *infra*, pp. 27a-33a) are not officially reported.

JURISDICTION

The judgment of the court of appeals was entered on June 6, 1977 (App. B, *infra*, pp. 10a-11a). The Commission's application for rehearing was denied on September 1, 1977 (App. C, *infra*, pp. 12a-13a). The mandate of the court of appeals issued on September 9, 1977. On August 26, 1977, Mr. Justice Powell extended the Commission's time for filing a petition for a writ of certiorari to and including November 3, 1977. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 52 Stat. 831, as amended, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Whether the Commission has authority under the Natural Gas Act to permit lessee/producers of natural gas to pass through to interstate customers the producers' royalty costs that are based on the unregulated intrastate market price of natural gas.

2. Whether the Commission has authority under the Natural Gas Act to permit lessee/producers of natural gas to pay royalties "in kind" in the form of natural gas that the landowner/lessors can then sell on the intrastate market, and thus to permit producers to abandon certificated interstate service in quantities of gas solely for the financial benefit of the lessors.

STATUTES INVOLVED

Section 4(a) of the Natural Gas Act, 52 Stat. 822, as amended, 15 U.S.C. 717c(a), provides:

> All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is declared to be unlawful.

STATEMENT

Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell) sell gas produced from the Gibson Field, in Terrebonne Parish, Louisiana to United Gas Pipe Line Company (United). The gas is produced under leases obtained by Pennzoil and Shell from Williams, Inc. (Williams) dated August 29, 1934, and July 24, 1952. Each lease provides for payment of a royalty equal to a fixed percentage ($\frac{1}{8}$ in the 1934 lease; $\frac{1}{4}$ in the 1952 lease) of the value of

the gas produced, calculated at the "market rate" or "market price" prevailing at the well (App. D. *infra*, p. 13a).

Royalties under the leases have always been paid on the basis of the regulated rates at which the gas from the leaseholds has actually been sold in interstate commerce. However, in 1973 and 1974 Williams demanded payment by Shell and Pennzoil of royalties based on intrastate market values of natural gas, ranging from 35 cents to 70 cents per Mcf (1,000 cubic feet) for the period October 1, 1971 through December 31, 1973, and 70 cents per Mcf thereafter. These market values substantially exceeded the rate ceilings established by the Commission for the sales of gas by Shell and Pennzoil. By a letter of June 5, 1974 Williams purported to terminate the leases for alleged underpayment of royalties due under the leases (App. D, *infra*, p. 15a).

In 1974, Pennzoil and Shell filed a petition in a state court in Louisiana praying for a judgment declaring that Pennzoil and Shell were properly discharging their royalty obligations under the leases. Williams filed an answer and a counterclaim claiming royalty underpayments of $3,731,683.79 (App. D, *infra*, p. 16a).

Shell, Pennzoil and Williams subsequently entered into a settlement agreement, under which Pennzoil and Shell would apply to the Commission for authority to pay a royalty based, in essence, on the higher of 78 cents per Mcf or 150 percent of the highest area or national rate permitted by the Com-

mission. Alternatively, Pennzoil and Shell would seek Commission authorization to abandon that portion of the gas sold under the leases which is attributable to Williams' royalty interest, *i.e.*, $\frac{1}{8}$ and $\frac{1}{4}$ of the gas produced under the 1934 and 1952 leases, respectively, so that that portion of the gas could be paid in kind to Williams for sale on the intrastate market. Accordingly, Pennzoil and Shell filed petitions with the Commission seeking special relief from the area and national rates established by the Commission to permit them to pass through to United the higher royalty rates called for in the settlement or, if this relief was denied, to permit them to abandon to Williams the portion of the gas produced under the leases that was attributable to Williams' royalty interests ("royalty gas") (App. D. *infra*, p. 16a).

After a hearing on the petitions, the Commission in January 1976 issued an opinion (App. D, *infra*, pp. 14a-26a) affirming the initial decision of the administrative law judge denying the requested relief. With respect to the requested rate increase, the Commission observed that while it did not have jurisdiction over the royalty owners or over the royalty payments made to them by producers,[2] it did have jurisdiction over the rates charged by producers to an interstate pipeline (*id.* at 21a-22a). The Commission concluded that it had no authority under the Natural Gas Act to grant the requested rate increase, stating (*id.* at 22a-23a):

[2] *Mobil Oil Corporation* v. *Federal Power Commission*, 463 F. 2d 256 (C.A. D.C.), certiorari denied, 406 U.S. 976.

In the instant proceeding, the impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates. As such, we cannot permit any incremental royalty costs resulting from this settlement, or resulting from any judgment by a state court regarding royalty payments, to be passed on to the pipeline if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate. On this point, we note the Supreme Court's warning in *FPC* v. *Texaco*, [417 U.S. 380], that the Commission is not free to equate just and reasonable rates with the prices for gas in the marketplace. Accordingly, we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates. A contrary result would not ". . . afford consumers a complete, permanent, and effective bond of protection from excessive rates and charges" [quoting from *Atlantic Refining Company* v. *Public Service Commission of New York*, 360 U.S. 378, 388].

The Commission also concluded that abandonment of the royalty gas to Williams should not be authorized under 15 U.S.C. 717f(b) (App. D, *infra*, pp. 23a-24a). The Commission found that the supply of natural gas in the leaseholds was not so depleted as to warrant cessation of service, and that the public convenience and necessity would not be served by granting an abandonment authorization that would "likely result in the subject gas being diverted from the interstate market to the intrastate market" (App.

D, *infra*, p. 24a).[3] The Commission subsequently denied petitions for rehearing (App. E, *infra*, pp. 27a-33a) in an opinion and order reaffirming the reasons set forth in its initial opinion and rejecting contentions that this Court's decision in *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, established the authority of the Commission to allow royalty costs based on market value to be passed on to pipelines. The Commission stated that "[w]hile indicating that relief on some grounds may be possible [*Mobil Oil Corp.*] does not state under what conditions relief should be granted, nor does it define when the right to gain relief matures" (App. E, *infra*, p. 29a).

The court of appeals reversed the Commission's orders (App. A, *infra*, pp. 1a-9a). The court viewed *Federal Power Commission* v. *Texaco Inc.*, 417 U.S. 380, as inapplicable, apparently because "[t]his case deals with royalty cost under specific leases" (*id.* at

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[3] Moreover, the Commission disagreed with Shell and Pennzoil that the Commission was forced to choose between losing ⅛ or ¼ of the gas to the intrastate market as called for in the settlement, and possibly losing all of the gas if the leases were cancelled as a result of the state court litigation. Relying on its previous decision in *El Paso Natural Gas Co.*, 54 FPC 145, reversed *sub nom. Southland Royalty Co.* v. *Federal Power Commission*, 543 F. 2d 1134 (C.A. 5), certiorari granted, June 27, 1977, No. 76-1587, the Commission expressed the view that Williams could not unilaterally terminate deliveries to United if he terminated the leases. "[I]f the lease were cancelled and Williams were to undertake to sell the subject gas, Williams would simply assume the obligations of Pennzoil and Shell to continue service to United," unless the Commission authorized abandonment (App. D, *infra*, p. 24a).

6). Inasmuch as Commission rate regulation is cost-based, the court held that the Commission had erred in determining that it was not permitted to pass through to interstate customers the cost to lessee/producers of market value royalty payments. The court relied on *Mobil Oil Corp.* v. *Federal Power Commission, supra,* for the proposition that producers are entitled to special relief from the Commission if their royalty payments are higher than those provided for by the applicable area or natural rate established by the Commission (*id.* at 7).

On the issue of alternative relief, the court directed the Commission to reconsider its decision not to permit abandonment of the royalty portion of the gas. Relying on its decision in *Southland Royalty Co.* v. *Federal Power Commission*, 543 F. 2d 1134 (C.A. 5), certiorari granted, June 27, 1977, *Federal Power Commission* v. *Southland Royalty Co.*, No. 76-1587, the court held that the Commission had been mistaken in concluding that the gas, having once been dedicated to interstate commerce, could not be withdrawn from that service by the lessor without abandonment authorization in the event that the leases were terminated for failure to pay royalties based on the unregulated market price.[4]

[4] On the Commission's limited petition for rehearing, the court deleted from its opinion the final statement that "[i]t may well be that the 'present or future public convenience or necessity' will suggest the propriety of abandoning a fraction of the gas in Williams' property, rather than lose the entire amount from the interstate market. This decision is for the Commission." (App. C, *infra*, pp. 12a-13a). In its opinion on rehearing the court stated "[w]e agree with the Commission that the statement was premature, if construed to be decisional, and unnecessary with respect to our decision" (*id.* at 13a).

REASONS FOR GRANTING THE WRIT

This case presents two issues of substantial importance to the administration of the Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C. 717 *et seq.*: first, whether the Commission has authority to permit a producer to pass through to interstate customers royalty costs based on the unregulated market price of gas; and second, whether the Commission, in lieu of passing through such costs, may permit a producer to abandon a portion of his gas from dedicated interstate service. The ruling of the court of appeals that the Commission has authority to grant both types of relief will, unless overturned, allow the rate set by the Commission for sales of natural gas for resale in interstate commerce to be based to a significant extent on the unregulated rate prevailing in the market for intrastate sales. It will thus substantially undercut the Commission's effective regulation of interstate sales pursuant to the authority recognized by this Court in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672.[5]

[5] While it might be argued that the effect of the decision below is limited because the court of appeals held only that the Commission had authority to grant the requested relief, not that it was compelled to grant such relief, the court's holding and rationale indicate otherwise. The decision below rejected the Commission's view that the grant of relief would

The two issues presented here are among a number of related issues that all derive from the widespread use in gas leases of clauses that require the producer to pay royalties to the lessor based on the "market value" or "market price" of the gas sold. The first issue presented by such clauses is whether "market value" clauses refers to the regulated interstate market price at which the gas is actually sold, or the unregulated intrastate price which, in recent years, has been substantially higher than the interstate price.[6]

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be inconsistent with the regulatory scheme of the Act; it thus forecloses the Commission from denying relief on that ground. The decision would limit the Commission to reviewing the circumstances of each case to determine whether particular royalty costs were or were not permissible for other reasons—for example, whether they were imprudently incurred. The Commission would be precluded from denying relief on the ground that use of unregulated market prices as a basis for determining a significant component of the regulated rate would undermine the basic purpose of the Act.

[6] In *Lightcap* v. *Mobil Oil,* 221 Kan. 448, 562 P.2d 1, certiorari denied, October 3, 1977, No. 76-1694, the Supreme Court of Kansas construed certain "market value" royalty provisions involved in that case to mean the unregulated intrastate market, and required the producers to pay royalties on that basis. In *Mobil Oil Corp.* v. *Federal Power Commission,* 463 F. 2d 256, 265 (C.A. D.C.), certiorari denied, 406 U.S. 976, however, the court suggested that such a construction not only might "run counter to the intention of the parties, unless there is something to rebut the fair presumption that they contemplated interstate movement and market prices compatible therewith," but also might contravene public policy if not the Supremacy Clause. Although this Court denied certiorari in *Lightcap,* the petitioner has filed a petition for rehearing, and the Commission intends to file a memorandum in support of that petition in view of the relationship between the issue there and the issues presented in this case.

A second issue is whether the Commission has jurisdiction over royalty agreements.[7] A third issue, presented in this case, is whether, if "market value" royalty provisions refer to the intrastate market, the Commission has the authority to include the higher royalty in the producer's cost basis, and thus pass through the higher costs to interstate consumers. A fourth issue, also presented in this case, is whether the Commission alternatively may permit a producer to pay royalties in the form of gas that the lessor may then sell on the intrastate market, and thus abandon a portion of his gas from dedicated interstate service.

While this petition addresses the issues presented in this case, those issues cannot be considered in isolation from the other issues that are different facets of the same problem.

1. The decision below that the Commission may permit producers to base their interstate prices on royalty costs that are in turn based on the unregulated intrastate market value of natural gas is, we

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[7] In *Mobil Oil Corp.* v. *Federal Power Commission,* 463 F. 2d 256 (C.A. D.C.), certiorari denied, 406 U.S. 976, the court of appeals, reversing the Commission, concluded that royalty owners were not "natural gas companies" subject to Commission jurisdiction under the Act. The court did not appear to view its decision as having a decisive impact on royalty levels, however, since it apparently believed that the presumed intention of the parties to gas leases, as well as considerations of public policy and federal regulation, would lead courts to construe "market value" clauses to mean the regulated market at which the gas was actually sold and expected to be sold. See note 6, *supra.*

submit, contrary to decisions of this Court. In *Federal Power Commission* v. *Texaco Inc.*, 417 U.S. 380, this Court reaffirmed the well-established principle that the Commission's responsibility under the Natural Gas Act is to establish interstate rates at levels that are "just and reasonable" (15 U.S.C. 717c, 717d(a)), and that this responsibility is not met by establishing an interstate rate that is based solely on the unregulated marketplace. In that case the Court rejected a Commission rate order that sought to regulate the rates of small producers indirectly through the Commission's regulation of the rates of large producers and of pipelines who purchased gas from the small producers and whose cost of service was therefore based in part on the prices paid to small producers. Since the order appeared to permit the large producers and pipelines automatically to pass through prices paid to the small producers that were based on the prevailing unregulated market, the Court rejected it, stating (417 U.S. at 397-399):

> [W]e * * * stress that in our view the prevailing price in the marketplace cannot be the final measure of "just and reasonable" rates mandated by the Act. It is abundantly clear from the history of the Act and from the events that prompted its adoption that Congress considered that the natural gas industry was heavily concentrated and that monopolistic forces were distorting the market price for natural gas. * * * In subjecting producers to regulation because of anti-competitive conditions in the industry, Congress could not have assumed that "just and reasonable" rates could conclusively be determined by references to market price [footnote omitted].

See also *Federal Power Commission* v. *Sunray DX Oil Co.*, 391 U.S. 9, 25.

The same principles apply here. It is evident that for the Commission to permit a producer to base his interstate rate on royalty costs based on the intrastate market price would result in interstate rates which are in significant part "conclusively * * * determined by reference to market price."[8]

The court of appeals stated that *Texaco* was "inapplicable" to this case, but gave little indication of its reasons for that conclusion (App. A, *infra*, p. 6a). As *Texaco* itself indicates, the fact that royalty costs are one of several components of the producers' cost is immaterial; they are a significant component, and the principles affirmed in *Texaco* do not suggest that the Commission can determine a part of the interstate rate that it promulgates solely on the basis of the unregulated market so long as it does not determine the whole rate on that basis. The Act does not permit the Commission to depart from its obligation to establish just and reasonable rates up to a point, so long as it adheres to that standard the rest of the

[8] Contrary to the court of appeals' view (App. A, *infra*, p. 7a), royalty costs that are based on the intrastate market price of gas are different from other costs (*e.g.*, drilling costs), because allowing a producer to pass such royalty costs through to interstate customers results in a price for interstate gas that is based in part on the unregulated market price of *gas*, contrary to the principles established in *Texaco* and other decisions.

way.[9] As the Court said in *Texaco, supra,* 417 U.S. at 399, "the Act makes unlawful all rates which are not just and reasonable, and does not say a little unlawfulness is permitted."

2. The Commission's decision in this case is not inconsistent with *Mobil Oil Corp.* v. *Federal Power Commission,* 417 U.S. 283, relied on by the court below (App. A, *infra,* p. 7a). The Court in *Mobil* upheld an area rate promulgated by the Commission. In response to Mobil's objection that the Commission had failed to provide for automatic rate adjustments to accommodate anticipated increased royalty costs, the Court observed that "Mobil's argument is hypothetical at this stage and * * * in any event an affected producer is entitled to seek individualized relief." 417 U.S. at 328. In making that observation, the Court did not discuss or purport to determine the entitlement to relief under all circumstances, or to decide in particular whether a producer would be

[9] Moreover, in practice, as in this case, the Commission is usually required to discharge its responsibilities under the Act by determining the justness and reasonableness of particular cost components presented to it for consideration. Accordingly, in this case the Commission stated (App. D, *infra,* p. 22a):

> [W]e cannot permit any incremental royalty costs * * * to be passed on to the pipeline if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate.

The Commission's conclusion was not incorrect simply because other cost components of the producers' rate were just and reasonable.

entitled to a rate increase to reflect royalty costs based on the unregulated market.

This Court in *Mobil* merely recognized that the Commission may grant special relief in some instances where actual costs are higher than those provided for in the regulated rate. It does not follow that the Commission may permit royalty payments based on the unregulated price of the very commodity that is subject to federal regulation—natural gas—to be borne ultimately by the consumers of gas sold in interstate commerce. If royalty costs determined by the unregulated price of gas sold in intrastate commerce were passed on to the interstate consumer, a different category of interstate gas would be created, the price for which would be determined in substantial part by intrastate market values and would fluctuate with those values. As recognized in *Texaco,* this would be no regulation at all.

3. The court below also erred in concluding that the Commission had authority under the Act to permit the producer, in lieu of passing through increased royalty costs to its interstate customers, to pay its lessors royalties in the form of gas which they could sell on the intrastate market, thus abandoning that gas from the interstate service to which it had been dedicated. As the Commission correctly found, neither of the two conditions for abandonment under Section 7(b) of the Act, as amended, 15 U.S.C. 717f(b), had been met. First, the available supply of gas had not been "depleted to the extent that continuation of service is unwarranted." Second, there was no basis for

finding that "the present or future public convenience and necessity permit such abandonment." The standard by its terms refers to the *public* convenience and necessity; it does not justify abandonment simply to serve the financial interests of royalty owners or producers.[10]

4. If, as we contend, the Commission may not under the Natural Gas Act permit producers to pass through royalty costs based on unregulated market prices, or alternatively to abandon a portion of their gas, we recognize the possibility—which concerned the court below (App. A, *infra*, p. 8a)—that producers might be caught between state court decisions that "market value" leases refer to the unregulated market and the Commission's refusal to pass through such market value royalty costs or permit abandonment of dedicated gas.[11] While we believe that in any event

[10] Moreover, the Commission concluded that there was no basis for permitting abandonment of a portion of the gas through payment in kind to avoid abandonment of all of it in the event the lessors terminated the leases since under the Commissions decisions, a lessor may not terminate certified interstate service commenced by his lessee without abandonment authority from the Commission under Section 7(b). The validity of those decisions is now pending before this Court in *Federal Power Commission* v. *Southland Royalty Co.*, No. 76-1587, certiorari granted, June 27, 1977, and this aspect of the instant case should at least await resolution of that case.

[11] As yet there has been no state court ruling in this case on the meaning of the royalty clauses in the leases involved; the parties by their settlement pretermitted that question pending the outcome of this proceeding. As the Commission recognized, however (App. D, *infra*, p. 22a), "the impetus of the settlement" was the unregulated market price of gas.

the Commission's position is mandated by the Act and the Act's purpose to protect interstate consumers of gas, it should be noted that there are possible avenues of relief for producers faced with demands from lessors that their royalty costs be based on the unregulated price of natural gas.

One type of relief could be this Court's limited reshaping of the holding by the court of appeals in *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F. 2d 256 (C.A. D.C.), certiorari denied, 406 U.S. 976, that landowner/lessors are not natural gas companies under the Act and that accordingly neither they nor their royalty agreements are subject to Commission jurisdiction. Such a reshaping would not necessarily require a determination that landowner/lessors are fully jurisdictional in the sense, for example, of being required to make filings with the Commission. Rather, it would be sufficient for this Court to determine that despite the nonjurisdictional status of landowner/lessors, royalty payments are nevertheless subject to regulation in the sense that producer/lessees need not pay royalties which exceed the amounts permitted by the Commission to be passed on to jurisdictional pipelines.

Such a determination, we submit, would be consistent with this Court's recognition that when Congress passed the Natural Gas Act, it "did not desire * * * that an important aspect of this field be left unregulated," but intended instead to establish a comprehensive regulatory scheme. *Federal Power Commission* v. *Transcontinental Gas Pipe Line Corp.*, 365

U.S. 1, 19. The Act "was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, 388. See also *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, where this Court, reversing the Commission, held that the Commission had jurisdiction not only over pipelines and their rates but also over the rates at which producers sell natural gas to pipelines for resale in interstate commerce, on the ground that those rates "may have a direct and substantial effect on the price paid by the ultimate consumers." 347 U.S. at 685.

An alternative, though related, type of relief for producers would be a determination by this Court that lower courts err when they interpret "market value" leases that underlie interstate sales as requiring royalty payments based on the intrastate market price of the gas. One such state court determination was the basis of a petition for a writ of certiorari to the Kansas Supreme Court, *Mobil Oil Corp.* v. *Harry Lightcap, et al.*, No. 76-1694. Although this Court denied certiorari in that case on October 3, 1977, we are advised that the petitioner on October 28, 1977, filed a petition for rehearing of the decision denying certiorari. As noted (note 6, *supra*), the Commission intends to file a memorandum in support of that petition for rehearing. In view of the relationship between that issue and the other issues discussed in this petition, we believe that the construction of a "market value" lease provision is not solely a question of state law, but is a question of federal law

under the Natural Gas Act. Our belief rests on the principle that "[t]he federal regulatory scheme leaves no room either for direct state regulation of the prices of interstate wholesales of natural gas * * * or for state regulations which would indirectly achieve the same result." *Northern Natural Gas Co.* v. *State Corporation Commission of Kansas*, 372 U.S. 84, 91; footnote omitted. A decision by this Court that market value leases underlying interstate sales must be interpreted in light of the regulated rate of those sales would obviate any bind on producer/lessees between royalties based on intrastate prices and the impermissibility of the Commission's allowing the flow-through of such market value royalty costs.

5. It is axiomatic that the Natural Gas Act, like other federal regulatory legislation, should be interpreted in furtherance of the Act's general purpose to protect consumers by effective regulation of natural gas wholesale rates. Cf. *Securities and Exchange Commission* v. *Ralston Purina Co.*, 346 U.S. 119; *United States* v. *Southwestern Cable Co.*, 392 U.S. 157; *United States* v. *Bacto-Unidisk*, 394 U.S. 784. The Commission, accordingly, concluded that it is not permitted to pass through market value royalty payments that are based on the unregulated price of natural gas or to permit abandonment of gas dedicated for interstate service solely to accommodate the financial interests of private parties. The contrary holding of the court of appeals would significantly impair the Commission's ability to implement one of the Act's basic objectives, and therefore warrants review by this Court.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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NOVEMBER 1977.

APPENDIX A

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

Nos. 76-1626, 76-1831 and 76-2128

PENNZOIL PRODUCING COMPANY, SHELL OIL COMPANY, UNITED GAS PIPE LINE COMPANY, PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT

June 6, 1977

Petitions for Review of an Order of Federal Power Commission (Texas Cases).

Before CLARK, RONEY and TJOFLAT, Circuit Judges.

RONEY, Circuit Judge:

Caught in the squeeze between the regulated price of its gas, which price included royalty costs at the interstate price, and the claims of landowners for increased royalty payments based on higher intrastate rates, the gas producers petitioned the Federal Power Commission for relief. Two alternatives were given the Commission: *first*, let the producers' interstate price be increased by the amount of increased royalty the producers will have to pay as determined by state litigation or settlement of pending lawsuits; or, *second*, let the producers "abandon" the royalty

portion of gas produced so that gas can be delivered to the royalty owner in kind, unburdened by the restrictive interstate price.

As to the first alternative, the Federal Power Commission failed to realize it had the authority to grant relief. As to the second, the Federal Power Commission misunderstood the law as it has now been defined in *Southland Royalty Co.* v. *FPC*, 543 F.2d 1134 (5 Cir. 1976). We reverse and remand for further consideration.

Due to the gross disparity between the higher unregulated prices of intrastate gas sales and the lower regulated prices of interstate sales,[1] lessors, whose royalty payments are determined by the "market value" or the "market price" of the gas, have brought numerous suits against the interstate producers-lessees claiming royalty payments based on rates higher than those prescribed by the Federal Power Commission.[2] Many of these long-term leases were entered into long before this disparity in prices arose, and some even before the Commission began regulating rates for interstate gas sales.[3] Thus, neither lessor

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[1] *See Southland Royalty Co.* v. *FPC*, 543 F.2d 1134 (5th Cir. 1976).

[2] *See, e.g., Phillips Petroleum Co.* v. *Bynum*, 155 F.2d 196 (5th Cir.), *cert. denied*, 329 U.S. 714, 67 S.Ct. 44, 91 L.Ed. 620 (1946); *Foster* v. *Atlantic Refining Co.*, 329 F.2d 485 (5th Cir. 1964); *Texas Oil & Gas Corp.* v. *Vela*, 429 S.W.2d 866 (Tex. 1968).

[3] Pennzoil Producing Company and Shell Oil Company sell in interstate commerce natural gas produced from Louisiana acreage leased from Williams, Inc. Pennzoil operates under a

nor lessee anticipated the problem that would arise over the nondefined terms in the leases: "market value" and "market price."

In a lawsuit filed on May 24, 1974, and currently pending in Louisiana state court,[4] a lessor asserted a royalty claim based on intrastate prices for natural gas, which greatly exceed the ceiling rates established by the FPC for interstate sales. After Williams, Inc. demanded by letter payment of royalties based on intrastate rates, Shell and Pennzoil brought the lawsuit seeking a judgment declaring that their royalty obligations were properly discharged by payments based on Commission-established rates. Williams counterclaimed for underpayment of royalty obligations in the amount of $3,731,783.79. On June 18, 1975, Shell, Pennzoil and Williams entered into a settlement agreement providing two major alternatives —one involving monetary payments, and the other involving payments of gas in kind—either being dependent on FPC authorization.

The first alternative provided that the payment of royalties would be based on the higher of the following prices: (1) 78¢ for Mcf for 1975 with annual

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1934 lease, while Shell operates under a 1[illegible] and a 1952 lease. The 1934 lease provides for royalty payments equal to one-eighth of the value of the gas produced, calculated at the "market rate" prevailing at the well. The 1952 lease contains a similar provision, requiring royalty payments equal to one-fourth of the value of the gas produced, calculated at the "market price" prevailing at the well.

[4] *Shell Oil Co. & Pennzoil Producing Co.* v. *Williams, Inc., et al.*, Docket No. 573-581, Civ.D.Ct., Orleans Parish, La.

increases of 1.5¢ per Mcf; or (2) 150% of the highest area or national rate permitted by the FPC. Pennzoil and Shell would then flow through these incremental royalty costs to their customer, United Gas Pipe Line Company. Although the FPC does not have jurisdiction over the amount paid royalty owners, *Mobil Oil Corp.* v. *FPC*, 149 U.S.App.D.C. 310, 463 F.2d 256 (1971), *cert. denied*, 406 U.S. 976, 92 S.Ct. 2409, 32 L.Ed.2d 676 (1972), it does have authority over interstate rates charged by the producers. *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035 (1954); section 4 of Natural Gas Act, 15 U.S.C.A. § 717c. Thus, special relief from the ceiling rates established in FPC Opinion Nos. 598 [5] and 699 [6] is required for petitioners to pass these costs on to United.

The second alternative provided that in lieu of the increased monetary royalty payments, Shell and Pennzoil would deliver to Williams its royalty share of the gas in kind for sale in any market, which presumably would bring the higher intrastate prices. This second proposal would require the FPC's consent to the

[5] *Southern Louisiana Area Rate Proceeding*, 46 FPC 86 (1971), *aff'd sub nom., Placid Oil Co.* v. *FPC*, 483 F.2d 880 (5th Cir. 1973), *aff'd sub nom., Mobil Oil Corp.* v. *FPC*, 417 U.S. 283, 94 S.Ct. 2328, 41 L.Ed.2d 72 (1974).

[6] Just and Reasonable National Rates for Sales of Natural Gas From Wells Commenced on or after January 1, 1973, and New Dedications to Interstate Commerce on or after January 1, 1973, 51 FPC 2212, *aff'd sub nom., Shell Oil Co.* v. *FPC*, 520 F.2d 1061 (5th Cir. 1975), *cert. denied*, 426 U.S. 941, 96 S.Ct. 2661, 49 L.Ed.2d 394 (1976).

abandonment of that portion of gas attributable to Williams' royalty interests, as required by section 7(b) of the Natural Gas Act, 15 U.S.C.A. § 717f. *Sunray Mid-Continent Oil Co.* v. *FPC*, 364 U.S. 137, 153, 80 S.Ct. 1392, 4 L.Ed.2d 1623 (1960).

In FPC Opinion Nos. 753 [7] and 753-A,[8] the Commission denied either form of relief. *First*, the Commission denied it had authority to allow producers of natural gas to increase their rates above the FPC ceiling set for gas sold in interstate commerce to reflect the increased cost of "market value" or "market price" royalty obligations under existing leases. *Second*, the Commission held that "present or future public convenience or necessity" did not permit the abandonment of the royalty portion of the gas, which had been dedicated to interstate commerce by the lessees. Section 7(b) of Natural Gas Act, 15 U.S.C.A. § 717f (b). The petitions for review attack both of these decisions.

Opinion 753 defined the "real issue" in this case to be whether the FPC "can legally grant any form of rate relief above either an area or nationwide just and reasonable rate solely because the producer selling the gas in interstate commerce *may* be obligated to make a royalty payment based not upon the regulated price the producer receives for the gas, but rather on the 'market value' of the gas." Relying on

[7] Opinion and Order Denying Special Relief and Abandonment, FPC Docket Nos. RI 76-8, -10 (January 30, 1976).

[8] Opinion and Order Denying Rehearing, FPC Docket Nos. RI 76-8, -10 (February 27, 1976).

FPC v. *Texaco, Inc.*, 417 U.S. 380, 94 S.Ct. 2315, 41 L.Ed.2d 141 (1974), the Commission concluded that it was "not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates."

Texaco, however, is inapplicable to the instant case. *Texaco* dealt with the question of the effect of *intrastate* prices of gas on *interstate* rate regulation. The Supreme Court held that the final measure of "just and reasonable" rates, mandated by sections 4 and 5 of the Act, could not be the prevailing price in the unregulated marketplace. Prompting this holding was the historical justification for general regulation of interstate prices, to prevent excessive profiteering by members of the heavily concentrated and monopolistic natural gas industry through distorted market prices. 417 U.S. at 397-398, 94 S.Ct. 2315. Thus, the Supreme Court held that other factors must be taken into consideration. 417 U.S. at 399, 94 S.Ct. 2315. This case deals with royalty cost under specific leases.

The Federal Power Commission has taken a cost plus profit approach to gas rate regulation. A cost-based methodology was approved by the Supreme Court in *Permian Basin Area Rate Cases*, 390 U.S. 747, 88 S.Ct. 1344, 20 L.Ed.2d 312 (1968). One of the components of a producer's costs is clearly its royalty expense, representing the amount a producer must pay to the landowner for the privilege of extracting gas from the reserves underlying his land. *Shell Oil Co.* v. *FPC*, 520 F.2d 1061, 1068 (5th Cir. 1975), *cert. denied*, 426 U.S. 941, 96 S.Ct. 2661, 49 L.Ed.2d 394

(1976). This cost petitioners seek to pass through to their customer, United, through a rate increase. They do not seek to increase their profits but merely to maintain those margins already determined by the Commission to be just and reasonable in its earlier rate proceedings. Because the Commission does not have jurisdiction over the amount of royalties charged by the lessor under a natural gas lease, *Mobil Oil Corp.* v. *FPC*, 149 U.S.App.D.C. 310, 463 F.2d 256, 263, *cert. denied*, 406 U.S. 976, 92 S.Ct. 2409, 32 L.Ed.2d 676 (1972), the only way in which petitioners-lessees can protect themselves from loss of profits in the event of an adverse state court decision is to ask for an increase in the allowable rates to be charged their customers.

This is not to say that every additional cost must be passed through to the customer to protect a producer's level of profits. The Commission has authority to consider the reasonableness of any costs incurred. *Mobil Oil Corp.* v. *FPC*, *supra*, at 263. Determination of the reasonableness of a cost necessarily requires consideration of market price. In all probability, the reasonableness of a great many costs of gas production must be determined by the prevailing market price in an uncontrolled market. The Commission has failed to suggest why royalty costs in an uncontrolled market are any different from any other cost. *Permian* and *Shell Oil* should have been looked to for guidance by the Commission, rather than *Texaco*.

Petitioners followed the proper procedures in petitioning the Commission for special relief and were entitled to a determination of the merits of their requests. In *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283, 94 S.Ct. 2328, 41 L.Ed.2d 72 (1974), *aff'd Placid Oil Co.* v. *FPC*, 483 F.2d 880 (5th Cir. 1973), decided the same day as *Texaco*, the Supreme Court, in response to Mobil's complaint that the FPC failed to provide automatic adjustments in area rates to compensate for anticipated higher royalty costs, reiterated the Court of Appeals' finding that " '[i]f, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief.' " 417 U.S. at 328, 94 S.Ct. at 2355. Pennzoil and Shell have been put in such a bind. If they lose the state court litigation, they are faced either with termination of their leases, which could divert the entire amount of gas from interstate commerce, or with increased royalty payments, which would absorb funds otherwise available for exploration and development.

In denying abandonment of the royalty portion of the gas, which is allowed under section 7(b) of the Natural Gas Act only when "the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted," or when "the present or future public convenience or necessity permit such abandonment", the Commission relied on its decision in *El Paso Natural Gas Co., et al.*, FPC Opinion No. 737 (July 11, 1975), *appeal then pending sub nom., Southland Royalty Co.* v. *FPC*, 5 Cir., 543 F.2d

1134 (1976). The Federal Power Commission held in *El Paso* that once a fixed-term lessee dedicates gas to interstate commerce, the lessor cannot withdraw that gas from interstate commerce absent Commission approval, upon termination of the lease. Thus the Commission was under the impression that Williams' gas was trapped in the interstate market, whether or not the leases were terminated.

This Court reversed the Commission's decision in *Southland Royalty Co.* v. *FPC*, *supra*, and held that a lessee could not dedicate to interstate commerce the gas remaining at the expiration of his fixed-term lease. Thus the Commission was acting under the wrong legal premise. It is appropriate to remand this issue to the Commission for reconsideration in light of *Southland Royalty*. It may well be that the "present or future public convenience or necessity" will suggest the propriety of abandoning a fraction of the gas in Williams' property, rather than lose the entire amount from the interstate market. This decision is for the Commission.

REVERSED AND REMANDED.

APPENDIX B

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

OCTOBER TERM, 1976

76-1626
Nos. 76-1831
76-2128

FPC Nos. RI76-8 and RI76-10

PENNZOIL PRODUCING COMPANY, ET AL., PETITIONERS

versus

FEDERAL POWER COMMISSION, RESPONDENT

Petitions for Review of an Order of the
Federal Power Commission (Texas Cases)

Before CLARK, RONEY and TJOFLAT, Circuit Judges.

JUDGMENT

This cause came on to be heard on the petitions of Pennzoil Producing Company, Shell Oil Company and United Gas Pipe Line Company for review of an order of the Federal Power Commission of the United States, and was argued by counsel:

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the order of the Federal Power Commission in this cause be, and the same is hereby reversed: and that this cause be, and the same is hereby remanded to the Federal Power Commission in accordance with the opinion of this Court.

June 6, 1977

APPENDIX C

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

Nos. 76-1626, 76-1831, 76-2128

PENNZOIL PRODUCING COMPANY, ET AL., PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT

Sept. 1, 1977

Petitions for Review of an Order of Federal Power Commission (Texas Cases).

ON PETITION FOR REHEARING

(Opinion June 6, 1977, 5 Cir., 1977, 553 F.2d 485)

Before CLARK, RONEY and TJOFLAT, Circuit Judges.

PER CURIAM:

In its petition for rehearing, the Federal Power Commission asserts that language in the opinion may erroneously indicate the prejudgment of an issue not before the Court, *i.e.*, the effect of our decision in *Southland Royalty Co.* v. *FPC*, 543 F.2d 1134 (5th Cir. 1976) on a state court termination of a lease, particularly one not limited by a fixed-term.

In order to pull from the opinion any indication as to how *Southland* might apply to the facts of this case, we delete from our opinion the last two sentences found at the end of the final paragraph, which read as follows:

> It may well be that the "present or future public convenience or necessity" will suggest the propriety of abandoning a fraction of the gas in Williams' property, rather than lose the entire amount from the interstate market. This decision is for the Commission.

We agree with the Commission that the statement was premature, if constructed to be decisional, and unnecessary with respect to our decision.

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby DENIED.

APPENDIX D

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Richard L. Dunham, Chairman; Don S. Smith, John H. Holloman III, and James G. Watt.

Docket No. RI76-8
Docket No. RI76-10

PENNZOIL PRODUCING COMPANY
SHELL OIL COMPANY

OPINION NO. 753

OPINION AND ORDER
DENYING SPECIAL RELIEF
AND ABANDONMENT

(Issued January 30, 1976)

Pennzoil Producing Company (Pennzoil) on July 1, 1975, and Shell Oil Company (Shell) on July 18, 1975, filed applications seeking special relief from the just and reasonable rates [1] established under Opinion

[1] Sections 4(a) and 5(a) of the Natural Gas Act, require that all rates received by a "natural gas company" be "just and reasonable". 52 Stat. 822, 823 (1938); 15 U.S.C. §§ 717c(a), 717d(a) (1970).

See, e.g., FPC v. *Texaco Inc.*, 417 U.S. 380 (1974).

Nos. 598 [2] and 699 [3] in order to flow through to their customer, United Gas Pipe Line Company (United), higher royalty rates called for in a settlement agreement dated June 18, 1975, with their lessors, Williams, Inc. and others (Williams).

The gas involved is produced in the Gibson Field, Terrebonne Parish, Louisiana, from leases with Williams dated August 29, 1934, and July 24, 1952. The 1934 lease provides for payment of a royalty equal to one eighth (1/8) of the value of the gas produced calculated at the "market rate" prevailing at the well. The 1952 lease provided for a royalty of one-fourth of the value of the gas calculated at the "market price" prevailing at the well. By letters dated June 7, 1973, and March 27, 1974, Williams demanded payment by Shell and Pennzoil of royalties based on market values ranging from 35 cents to 70 cents per Mcf for the period October 1, 1971, through December 31, 1973, and 70 cents per Mcf thereafter. By letter of June 5, 1974, Williams purported to terminate the leases (Exhibit No. 3).

[2] *Area Rate Proceeding et al. (Southern Louisiana Area)*, 46 FPC 86 (1971), *aff'd sub nom. Placid Oil Co.* v. *FPC*, 483 F.2d 880 (5th Cir. 1973); *aff'd sub nom. Mobil Oil Corp.* v. *FPC* 417 U.S. 283 (1974).

[3] *Just And Reasonable National Rates For Sales Of Natural Gas From Wells Commenced On Or After January 1, 1973, And New Dedications To Interstate Commerce On Or After January 1, 1973*, Docket No. R-389-B, Opinion No. 699, 51 F.P.C. 2212 (June 21, 1974), *reh. denied*, Opinion No. 699-H, 52 F.P.C. —— (December 4, 1974, *aff'd sub nom. Shell Oil Co.* v. *FPC*, 520 F.2d 1061 (5th Cir. 1975).

On May 24, 1974, Shell and Pennzoil filed a petition in the Civil District Court in the Parish of Orleans, Louisiana [4] praying for a Judgment declaring that the petitioner's interpretation of "market rate" and "market price" was correct, that they have properly discharged their royalty obligations on the basis of Commission established rates and that the leases are still in effect (Exhibit No. 4). They also asked for a temporary restraining order, which was granted. Williams filed an answer and reconventional demand (counterclaim), with an amendment alleging market prices for the gas for the period October 1, 1971, to April 30, 1975, ranging from $.35 to $1.40 per Mcf and underpayments of $3,731,683.79 (Exhibit Nos. 5, 6).

In the settlement of June 18, 1975, Pennzoil and Shell would apply to the Commission for authority to pay a royalty based on a price of 78 cents per Mcf for 1975 and 1.5 cents per Mcf more each year or 150 percent of the highest area or national rate permitted, plus Louisiana severance tax, Federal taxes and Btu adjustment. Alternatively, Pennzoil and Shell would ask for authority to deliver to Williams one-eighth or one-fourth, as the case may be, of the gas attributable to their respective interests, and to abandon their sales of this gas to United.

If the Commission approves the price alternative, Pennzoil and Shell would pay a royalty for 1974 equal

[4] *Shell Oil Company and Pennzoil Producing Company* v. *Williams Inc., et al,* Civ.D.Ct. Orleans Parish, La., Docket No. 573-581.

to what would have been paid based on a price of 45 cents per Mcf, but only to the extent the Commission permits them to recover such amounts from United. If the Commission approves the alternative delivery of the gas to Williams, Pennzoil and Shell would pay an additional royalty until the date of a final order.

After the Commission's order becomes final and non-appealable the parties would dismiss their Louisiana civil suit. Pennzoil and Shell are to use their best efforts to obtain the approval of the Commission. If the Commission refuses to do so on or before February 1, 1976, either Williams or Shell and Pennzoil, acting together, may terminate the agreement. In separate agreements United agreed to make the additional payments or to release the royalty gas (Exhibit Nos. 7, 8).

In its order of August 29, 1975, the Commission denied the petitions of Pennzoil and Shell for special relief and prescribed a hearing on the issue relating to the abandonment of the royalty gas. On September 22, 1975, the Commission granted rehearing and provided that the hearing cover the issue of special relief. The hearing was held before Presiding Administrative Law Judge Samuel Z. Gordon on September 23, 1975, at which Shell, Pennzoil and United presented evidence. Shell was afforded additional time to present certain factual data as to prices, volumes and cost and did so on September 29, 1975. The costs it presented were derived from national costs with a figure for operating expenses from the 1934 and 1952

leases substituted for the national figure. Shell was given opportunity to file additional cost data but advised that it did not intend to do so (Exhibit No. 10), although it filed answers to written interrogatories submitted by the Commission staff.

In his initial decision issued November 24, 1975, the Judge denied special relief on the ground that the producer must establish that his overall costs incurred in the operation of the particular well or group of wells are higher than area or nationwide rates, or that his out-of-pocket expenses will exceed revenues. Pennzoil, he said, had made no such showing and Shell had attempted to use the nationwide costs with a 4.5 cents figure for operating costs and a royalty figure based on $1.40 per Mcf market value.

The Judge also determined that Pennzoil and Shell have not established that abandonment of the royalty interest is permitted by the public convenience and necessity. Williams has agreed to accept higher royalty payments computed on the basis of 78 cents per Mcf, he pointed out, and Shell has shown that it could absorb higher royalty costs while Pennzoil has not made a showing that it could not. Furthermore, the abandonment should be denied because William's claim is unadjudicated. He would also deny the requested surcharge for past royalties.

Exceptions were filed by Pennzoil, Shell, United, Mobil Oil Corporation (adopting those of Pennzoil and Shell) and the State of Louisiana, and a brief opposing exceptions was filed by Staff.

Since the filing of the exceptions Pennzoil on January 20, 1976, filed a motion for leave to lodge a document with the Commission and to comment on the Commission's Opinion No. 749 [5] prescribing rates for flowing gas. The document is a letter dated January 5, 1976, from counsel for Williams requesting answers to interrogatories in the Louisiana litigation and stating that Williams intended to reactivate the state proceedings as soon as possible under the settlement agreement. In its comments on Opinion No. 749 Pennzoil says that, as to the old gas, the royalty increment under the settlement would be added to the Opinion No. 749 rate,[6] rather than to the Southern Louisiana Area rate. Pennzoil argues that the Opinion No. 749 rate should apply even though it is granted special relief here [7] because this is not a typical relief case since all increased sums will be passed directly to the lessors. Since we are denying the requested relief as discussed below, it is not necessary to determine this issue.

Pennzoil objects to the Judge requiring project cost evidence, saying that the cost inquiry should be limited to the costs and revenues associated with the price

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[5] *Just And Reasonable National Rates For Sales Of Natural Gas From Wells Commenced Prior To January 1, 1973*, —— FPC ——, Opinion No. 749, Docket No. R-478, —— F.P.C. —— (December 31, 1975).

[6] The Opinion No. 749 rate is 23.5 cents per Mcf 23.5 cents per Mcf prior to July 1, 1976, and 29.5 cents per Mcf thereafter, subject to adjustments.

[7] *See* Opinion No. 749, at 48-49.

increase. It argues that the risks of the Williams litigation render the current price inappropriate and lease termination is a serious possibility. If Williams wins in the litigation, Pennzoil says, it might be able to sell the gas in intrastate commerce, or it might sell all of the gas under a new contract at 130 percent of the national rate under Section 2.56a(a)(2)(iii) of the Regulations[8] and Opinion No. 742[9], and for all of the gas this would be 27 cents per Mcf more than Pennzoil is currently collecting. It further contends that market value royalties involve considerations different from those involved in the determination of other items of cost since royalties are flowed-through to the lessor. Finally, it notes that substantial risks are avoided by an increase in average price from 40.91 cents per Mcf to 44.55 cents per Mcf or 3.64 cents, none of which inures to Pennzoil's benefit.

Shell makes similar arguments about the lack of necessity for showing overall costs, saying that proof of overall costs is not required in a special relief case. Likewise Shell argues that failure to approve the settlement risks interstate gas supply and threatens higher prices, and asks the Commission to consider the end result. United urges that the settlement be approved in the public interest as concerned with the certainty of gas supply and reasonable prices. Louisiana argues that the Judge failed to apply proper

[8] 18 C.F.R. § 2.56a(a) (2) (iii).

[9] *Small Producer Regulation*, Docket No. R-393, Opinion No. 742, —— FPC ——.

standards in denying rate relief contending that changed circumstances have made no longer appropriate the royalty cost assumptions that went into the applicable rate structures, and Louisiana supports the settlement as a reasonable and appropriate resolution of the issues. On the other hand the staff argues against reliance on non-cost factors and Shell's use of national cost figures, which it points out are only averages.

PRICE RELIEF

The real issue in this proceeding is whether the Federal Power Commission can legally grant any form of rate relief above either an area or nationwide just and reasonable rate solely because the producer selling the gas in interstate commerce *may* be obligated to make a royalty payment based not upon the regulated price the producer receives for the gas, but rather on the "market value" of the gas. Moreover, as in this proceeding, the question becomes somewhat speculative because of litigation between producer lessees and lessors over the extent of such royalty obligations.

While sympathetic to the plight of the producers who face or may face litigation on the value of royalties, we today must find that such producers are not entitled to rate relief. While we admittedly do not have jurisdiction over royalty owners as such[10] and, therefore, over royalty payments by producers to

[10] See *Mobil Oil Corporation* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1972).

lease owners, we do have jurisdiction over the rates charged by producers to the pipelines for sales of gas for resale in interstate commerce and those rates must be "just and reasonable".[11] Hence, if a producer desires to compute royalty payments based on a rate in excess of our applicable just and reasonable rate, he may unilaterally do so. However, if a producer attempts to flow this cost through to the pipeline and ultimately to the consumer, we must determine if this *incremental royalty cost* is just and reasonable. Yet, in making this finding, it would be inconsistent and contrary to the Commission's mandate to establish a just and reasonable rate and at the same time allow a producer selling at that just and reasonable rate to increase this rate for additional royalty payments which are based on other factors than the regulated rate.

In the instant proceeding, the impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates. As such, we cannot permit any incremental royalty costs resulting from this settlement, or resulting from any judgment by a state court regarding royalty payments, to be passed on to the pipeline if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate. On this point, we note the Supreme Court's warning in *FPC* v. *Texaco, supra*, that the Commission is not free to

[11] See *Mobil Oil Corporation v. FPC, et al.*, 417 U.S. 283 (1974); *FPC* v. *Texaco, Inc.*, 417 U.S. 380 (1974).

equate just and reasonable rates with the prices for gas in the marketplace. Accordingly, we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates. A contrary result would not ". . . afford consumers a complete, permanent, and effective bond of protection from excessive rates and charges." [12]

ABANDONMENT

Pennzoil argues that abandonment of the royalty portion of the gas should be allowed under Section 7(b) of the Natural Gas Act [13] as in the public convenience and necessity if price relief is not granted. Pennzoil says the choice here is between losing one-eighth of the gas and risking the loss of all of the gas. While United prefers the requests for increased rates, it says the Commission should approve the

[12] See *Atlantic Refining Company* v. *Public Service Commission of the State of New York,* 360 U.S. 378, 388 (1959).

[13] Section 7(b) provides:

> No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

52 Stat. 824 (1938); 15 U.S.C. § 717f(b) (1970).

requests to abandon the royalty portion of the gas if price relief is denied.

We find no reason to grant abandonment on the basis of this record. There is no showing "that the available supply of natural gas is depleted to the extent that the continuation of service is unwarranted, or that the present or future public convenience or necessity" requires that abandonment be authorized.

The supply of natural gas involved in this case is not depleted so abandonment may not be approved for that reason. Moreover, the public convenience and necessity, present or future, is not served by granting an abandonment authorization that would likely result in the subject gas being diverted from the interstate market to the intrastate market.

Since "there can be no withdrawal of that supply [of natural gas] from continued interstate movement without Commission approval" [14] once the gas is dedicated, we do not share the concern of Pennzoil and United that Williams could terminate deliveries to United even if the leases were cancelled as a result of state court litigation. If the lease were cancelled and Williams were to undertake to sell the subject gas, Williams would simply assume the obligations of Pennzoil and Shell to continue service to United. *El Paso Natural Gas Company, Texaco Inc.*, Docket Nos. CP75-209, CI75-594, Opinion No. 737, —— F.P.C. —— (July 11, 1975), *rehearing denied*, Opinion No. 737-A, —— F.P.C. —— (September 3, 1975), *rehearing granted* on limited issue, Opinion No. 737-B, —— F.P.C. —— (December 18, 1975), *appeal pending sub nom. Southland Royalty Co.* v. *F.P.C.*, No. 75-2851 (5th Cir.). In such a case, Williams would not be entitled to the status afforded a royalty owner by *Mobil Oil Corp.* v. *F.P.C.*, 463 F.2d 256 (D.C. Cir. 1971), but would be a natural gas company making sales for resale of natural gas in interstate commerce subject to the Commission's jurisdiction. *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 672 (1954). We, therefore, deny the alternative requests for abandonment.

[14] *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, 389 (1959).

SURCHARGE

Pennzoil argues that the surcharge contained in the settlement to pay Williams for alleged past underpayment of royalties was not settled in the Commission's orders, is not a retroactive rate increase, represents less than the full claim and should be allowed. For the reasons set forth above in denying the requested price relief, we also deny the requested surcharge.

The Commission further finds:

The initial decision issued November 24, 1975, in these proceedings denying the applications of Pennzoil and Shell for special relief or abandonment, and a surcharge should be affirmed for the reasons set forth above.

The Commission orders:

(A) The initial decision issued November 24, 1975, in these proceedings is affirmed for the reason set forth above.

(B) The petitions of Pennzoil and Shell requesting special relief or abandonment and a surcharge are denied.

(C) The motion to lodge a document and comment filed on January 20, 1976, is granted.

(D) Exceptions not granted are denied.

By the Commission.

[SEAL]

KENNETH F. PLUMB,
Secretary.

APPENDIX E

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Richard L. Dunham, Chairman; John H. Holloman III, and James G. Watt.

Docket No. RI76-8

PENNZOIL PRODUCING COMPANY

Docket No. RI76-10

SHELL OIL COMPANY

OPINION NO. 753-A

OPINION AND ORDER DENYING REHEARING

(Issued February 27, 1976)

Pennzoil Producing Company and Shell Oil Company on February 13, 1976, and United Gas Pipe Line Company (United) on February 26, 1976, have filed applications for rehearing of the Commission's Opinion No. 753 and order issued January 30, 1976. The Opinion and order relate to gas produced by Pennzoil and Shell in the Gibson Field, Terrebonne Parish, Louisiana and sold to their customer, United Gas Pipe Line Company. The lessors in the Field, Williams, Inc. and others (Williams), had demanded higher royalties based on the market price for the gas;

a civil suit in Louisiana had commenced on the applicability of the market price; and on June 18, 1975, Pennzoil, Shell and Williams had entered into a settlement agreement under which Pennzoil and Shell would apply to the Commission for authority, among other things, to pay a royalty based on a price of 78 cents per Mcf, or alternatively abandon the royalty gas to Williams. Pennzoil and Shell also agreed to pay Williams a surcharge for alleged past underpayment of royalties and proposed to flow through the increased royalties and the surcharge to United.

In its Opinion No. 753 and order the Commission, in adopting the initial decision of the Administrative Law Judge, denied the special relief, the surcharge and the abandonment. Pennzoil and Shell contend that the Commission is in error and, Pennzoil states that, while the settlement agreement was subject to cancellation by February 1, 1976, Williams has agreed that the settlement will not be cancelled before March 1, 1976.

In the first place Pennzoil contends that the Commission has authority to allow increased rates to reflect royalty payments based on prices in excess of ceiling rates. The Commission said that it was not free to allow royalty costs, which are based on market values, to be passed on to the pipeline as just and reasonable rates. Pennzoil cites *Placid Oil Co.* v. *F.P.C.*, 483 F.2d 880 (CA5, 1973), where the Court said that if producers are put in a bind by their royalty obligations they may petition the F.P.C. for individualized relief, and *Mobil Oil Corp.* v. *F.P.C.*,

417 U.S. 283 (1974), affirming *Placid* and saying that a producer affected by higher royalty obligations is entitled to seek individualized relief. While indicating that relief on some grounds may be possible, this case does not state under what conditions relief should be granted, nor does it define when the right to gain relief matures.

In *F.P.C.* v. *Texaco Inc.*, 417 U.S. 380 (1974), the Commission was instructed to insure "that the rates paid by pipelines, and ultimately borne by the consumers, are just and reasonable" and that "the prevailing price in the market place cannot be the final measure of just and reasonable rates mandated by the Act." While Pennzoil argues here that the price increase is based on a number of factors, including the risks of the Williams litigation, the propriety of the settlement, and the fact that it is not based on the full market price, it is plain that the royalty is to be based on 78 cents, which is the settlement's reflection of market prices, that are above the area ceiling prices.

The area ceiling prices are intended to be just and reasonable rates. The Commission was upheld in determining just and reasonable rates for the Southern Louisiana area in *Mobil, supra.* The Commission determined just and reasonable national rates in Opinions Nos. 699 and 699-H and was affirmed on appeal.[1] In arriving at the national rates costs of pro-

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[1] *Just and Reasonable National Rates for Sales of Natural Gas from Wells Commenced on or after January 1, 1973,* Opinion No. 699, 51 FPC 2212 (1974); Opinion No. 699-H, ——

duction were used and royalties were computed at 16 percent of total costs. (51 FPC at pp. 2272-2273) It is for these reasons that the Commission is not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates.

Pennzoil argues that it is an entirely different question when we are dealing with an incremental price that does not generate excessive profits, but *Texaco* says that "a little unlawfulness" is not permitted. In this connection *American Petrofina Company of Texas (Operator), et al.,* —— FPC ——, Docket Nos. RI75-17 and RI75-19, issued March 3, 1975, is not in point. In that case the company was given relief because of the costs of additional necessary compression. There was no question of the reasonableness of compression costs or whether they were determined on the basis of lower interstate prices or higher intrastate prices. Nor are the *El Paso Natural Gas Company,* —— FPC ——, Docket No. RP74-22, *et al.,* orders issued November 29, 1974, and January 29, 1975, in point. In that case the Commission had originally prevented El Paso from collecting a rate increase based on increased royalties which had not yet been paid, but in the cited orders we allowed such rate increases to go into effect subject to refund saying that El Paso had begun paying the increased royalty charges but our review raised a number of issues relating to the justness and reasonableness of

FPC ——, Docket No. R-389-B, issued December 4, 1974; *aff'd Sub. Nom. Shell Oil Co.* v. *F.P.C.*, 520 F.2d 1061 (CA 5, 1975).

the proposed rates that required further consideration by the Commission. Thus in *El Paso* the validity of the increased charges based on royalties was not determined.

Pennzoil further argues that the price increase is just and reasonable, pointing out the risks of the Williams litigation and contending that the gas may be diverted from the interstate market. Pennzoil also notes that no one has contended that the costs involved were improvidently occurred. These considerations are not controlling. The Commission does not have the power to base a part of the regulated price on the unregulated market value of intrastate gas. Pennzoil also objects to the statement that the Commission cannot permit incremental royalty costs resulting from any judgment by a state court from being passed on to a pipeline if the incremental costs are based on any other factors than the regulated just and reasonable rate. Pennzoil says that this is dicta and it should be eliminated. Since there is no state court judgment and it is indeed dicta, it will not be necessary to discuss it further at this time. Pennzoil's arguments on the issues of abandonment and surcharge are sufficiently covered in the original opinion, and need not be addressed again.

Shell has listed specifications of error that relate to the discussion of the Administrative Law Judge as well as to our discussion in Opinion No. 753. These matters have largely been covered. Shell contends, *inter alia,* that we have not considered the end result of our decision on the consumer, saying that the gas

supply may be lost. The gas supply here that is dedicated to interstate commerce cannot be diverted to intrastate commerce. At the same time, if royalty costs could be based on higher intrastate market values, the impact on the consumer could extend far beyond this case. It is not in the public interest that national rates be distorted in the manner contemplated by Shell, which would create a new species of interstate gas which would rise and fall with intrastate market values.

Also Shell says that the Commission has foreclosed any consideration of the market value royalty problem in any forum and has therefore deprived Shell of its property without due process of law. In this proceeding a hearing was held; the Presiding Judge issued an initial decision to which exceptions were taken; and the Commission considered the issues on the basis of the record. There is no dispute whatever about the facts relating to the computation of the proposed rates based upon market value royalties. Pennzoil, Shell and United have expressed their views, and the Commission determined that special relief should not be granted on the basis of market value royalties. United's contentions are covered by Opinion No. 753 and this Opinion.

The Commission further finds:

The assignments of error and grounds for rehearing of Opinion No. 753 and order in the applications for rehearing filed by Pennzoil, Shell, and United present no facts or legal principles that would warrant any

change in or modification of the Commission's Opinion No. 753 and order as supplemented by the above discussion.

The Commission orders:

The applications for rehearing filed by Pennzoil and Shell on February 13, 1976, and United on February 26, 1976, are denied.

By the Commission.

[SEAL]

KENNETH F. PLUMB,
Secretary.

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